

September 14, 2020

The Honorable Dustin Burrows  
Chairman, House Ways & Means Committee  
Texas Capitol Extension, Room E2.722  
Austin, Texas

Re: Comments Regarding Ways & Means Interim Charge #3

Chairman Burrows, Members of the Committee:

This committee has a vital and necessary responsibility to inform, guide and direct the Tax Policy for the State of Texas, its businesses and citizens. Fair and simple tax policy is one of the historic traits of the Texas Legislative Committee on Ways and Means and is a significant contributing factor to the “Texas Miracle” economic expansion we have enjoyed over the last couple of decades.

Interim charges provide the opportunity for the Ways & Means Committee to reflect on Tax Policy and “self audit” to determine if the tax policy of the past is still contributing to the environment that makes Texas the top state to start and open a new business. Interim Charge 3 is a great opportunity for that “self-audit”.

3. Study the role of the local option sales and use tax, including: an analysis of the available uses for those taxes, specifically economic development agreements; the statewide distribution of local tax rates; the proportion of the local government budget supported by sales and use taxes; the application of consistent sales sourcing rules; and the impact of shifting from origin to destination sourcing

The Charge outlines three main areas of exploration:

1. Use(s) of local option sales tax.
2. Economic development agreements
3. Sourcing rules

## Uses of Local Option Sales Tax

The Legislature has statutorily capped the local option sales and use tax to a maximum of two percent (2%). The breakdown of that total 2% varies based upon location but can generally follow a predictable pattern. Municipalities have authority to impose a 1% sales tax for general purposes. Anything above the standard municipal sales tax of 1% is generally for a special purpose of some kind, authorized by various governmental entities with the approval of the voters.

**General Use:** Municipal governments have a 1% sales tax that they can use for general governmental purposes. Most cities use the money in the same way that they utilize ad valorem tax revenue, to fund the general operations and obligations of the local government. Sales tax revenue is typically more volatile than property tax revenue, so in the budgeting process, municipal governments often direct sales tax revenue for slightly more discretionary expenditures that can be more easily suspended or postponed in times of economic crisis.

**Special Purpose:** Municipalities, Counties, Emergency Service Districts, and Transit Authorities also have additional special purpose sales tax authority. Cities may go above the standard 1% for special purposes that include Street Maintenance, Fire / Police Protection or Economic Development. All of these additional special purpose taxes must be approved by the voters. Some Counties have a special purpose sales tax dedicated to reducing the ad-valorem tax rate. ESD's utilize the sales tax for their fire or ems operations. Transit Districts utilize the tax for the purposes set out in their enabling statutes.

## **Economic Development Agreements:**

Chapter 380 of the Local Government Code allows a city to make a program payment out of its general fund for a variety of purposes. Cities have utilized Chapter 380 agreements as economic development incentive tools to attract and retain business and primary jobs. In many circumstances, the program payments authorized by Chapter 380 are pegged / indexed to the amount of sales tax generated by the company that is a party to the agreement. This is a best practice protecting the tax-payers of the community so that the 380 economic development incentive agreements don't result in a program payment that exceeds the fiscal benefit to the local government.

Chapter 380 agreements have been an integral part of the Texas Miracle, helping Texas and local governments compete and secure large economic development projects that created countless jobs in this state. Successful projects include helping Round Rock secure the Dell Corporate HQ and manufacturing facility over the state of Tennessee and small projects incentivizing rural main street retailers to improve historic building facades.

Over the last several years, there have been some more exotic uses of Chapter 380 agreements that seem to result in questionable economic development benefits. Like with other incentive programs (Chapter 313) more oversight, analysis and measurable primary job creation requirements could improve Chapter 380 and ensure the public's confidence in its importance in Texas' economic development tool box.

## Sourcing of Local Sales and Use Tax:

Origin vs Destination sourcing by a state defines whether a state emphasizes commerce, business and investment or it emphasizes use, consumerism and spending.

Texans and the Texas Legislature have long supported what is commonly called “origin sourcing” for local option sales tax. Traditionally, origin sourcing has been seen as a fair and easy way for local taxes to be assessed, collected and allocated. The premise being that the community that makes the sale/commerce possible, by supporting the business and its operations, is an appropriate location for the local tax.

The economic support theory has the added benefit of being business friendly and encourages a favorable business climate. A simple origin-sales and use tax makes it easy for a company to collect and remit the tax. Businesses know where they are located and they know the local officials who are more responsive to the needs of the business community. In turn, local governments seek to form a favorable business climate benefiting businesses, consumers and ultimately the local citizenry.

Under an origin sourcing tax regime, businesses know where their sales occur and what the tax rate is at the location of the sale. They aren’t saddled with the administrative burden and expense of allocating sales tax to multiple different jurisdictions. This makes it easier for businesses to open and begin remitting sales tax from day one, without anxiety over incorrectly collecting and remitting sales tax that could lead to an angry customer or a compliance visit from the Comptroller.

Furthermore, the tax policy informing a state’s decision to adopt origin sourcing over destination sourcing is found in the “support the producer” philosophy. Origin sales taxes benefit the community that made the commerce possible. Origin sales taxes support the local government and citizenry who established ordinances and local tax policy that favors opening and operating a business.

Much like state tax policy encourages states to compete for company locations, local governments also compete with their ordinances, codes and investment. Communities choose, sometimes out of necessity or opportunity, if they want commerce, bedrooms or a combination of both. The ordinances adopted, investments made and community culture developed over time enhance and enforce those decisions. Origin sourcing of sales tax is a fundamental factor in that community development.

## **Statutory Guidance:**

The “origin sourcing” statutes for the state of Texas are currently found in Chapter 321 (Municipal), Chapter 322 (MTA) and Chapter 323 (County) of the Tax Code, specifically in subsection 203 of those chapters. The Texas Legislature has taken several opportunities to review these provisions and consider both minor and substantive changes to Texas’ historic embrace of a business friendly origin sourcing policy. The following is a brief recap of significant historical and more recent instances where the Legislature has examined this topic in much the same way Interim Charge #3 directs the Ways & Means Committee to perform now.

**SB 582 (66<sup>th</sup>, 1979) by Farabee – *Relating to the imposition, levy, and collection of certain local sales, excise and use taxes; clarifying the imposition and allocation of local use tax; defining “place of business of the retailer” for local sales, excise, and use tax purposes.*** This bill established the current framework for Texas sourcing laws based upon the definition of a “place of business of the retailer”. The bill resulted from two court cases (*U.S. Steel v. Bullock* and *Dunnigan Tool and Supply v. Bullock*) that were brought based upon the interpretation of statutes regulating the imposition and sourcing of local sales tax. The bill established a bright line for companies with only one “place of business” in the state to source all local taxes to the jurisdiction where the place of business was located. The bill analysis states: *“The bill will treat in state and out of state merchants equitably, and will make it clear how to determine where a sale is consummated.”*

Because both court cases were not settled before the end of the 66<sup>th</sup> Legislature, the Ways & Means Committee was given an interim charge to review the bill and local sourcing methods, including destination sourcing. The Interim Report of the Ways & Means Committee recommended keeping the simple origin sourcing and place of business definitions from SB 582 over any other method, including the destination-sourcing method. The committee found that 90% of retailers in the state only report tax to a single location because they only have a single “place of business” in the state. A change to destination sourcing would increase the complexity of reporting and require 10 times as many Texas merchants to calculate and remit to multiple jurisdictions. The report recommended keeping origin sourcing and concluded: *“The definition of “place of business” contained herein makes issuing permits and reporting tax easier than other methods since it is tied to the outlet location.”*

**SB 147 (77<sup>th</sup>, 2001) by Ellis – *Relating to sales tax sourcing changes related to mobile telecommunications services.*** This bill clarified that sales tax on cellular / mobile telecom charges are sourced to the billing location of the primary customer. This was an industry sponsored bill that sought to bring Texas into compliance with the Federal Mobile Telecommunications Sourcing Act.

**SB 823 (78<sup>th</sup>, 2003) by Frasier – *Relating to administration of the sales and use tax and compliance with the Streamlined Sales and Use Tax Agreement.*** In 2003, Senator Frasier authored a bill that would require Texas to adjust sales tax statutes and rules to become compliant with the multistate Streamlined Sales and Use Tax Agreement (SSUTA). One component of the bill would have required Texas to change local sales tax sourcing from Origin to Destination. There was initial support for the bill in the Senate and it passed with a comfortable majority. Senator Nelson voted “no”. The bill did not receive a hearing in the House after small businesses and local governments realized the impact a change in sourcing might have on operations and budgets.

**NOTE:** SB 823 in Texas and similar efforts in other states led to the formation of the Coalition for Appropriate Sales Tax Law Enactment (CASTLE). This group was comprised of local governments from all over Texas and other origin states (Arizona, Washington, Tennessee, Virginia), and had as its stated goal the preservation of a state’s ability to maintain origin-sourcing for intrastate sales tax transactions. The group was quite active in Texas and included member cities representing both large and small including San Antonio, Fort Worth, Round Rock, Coppell, Carrollton, Waxahachie, Webster, Dickinson, Hill Country Village and others. The group concentrated its efforts in state legislatures and on a national level at the Streamlined Sales Tax Governing Board.

CASTLE commissioned an economic impact study by Ray Perryman in 2005 to examine the impact of a change from origin to destination sourcing for the state of Texas in general and to certain CASTLE member communities based in Texas. That report highlighted that almost 25% of the Texas population lived in an unincorporated area and therefore moving to destination-sourcing would reduce local sales tax revenue collections by millions.

CASLTE’s participation in national sales tax issues at NCSL, ALEC, FTA, MTC and the Streamlined Sales and Use Tax Agreement Governing Board meetings led those SSUTA member states to amend the SSUTA to allow states like Texas, California, Virginia, Tennessee, Illinois and others to fully participate in the multistate agreement and still maintain origin-sourcing for intrastate transactions.

**HB 2425 (78<sup>th</sup>, 2003) by McCall – *Relating to Fiscal Matters.*** In a nod toward the “origin vs destination” sourcing issue that doomed Senator Frasier’s SB 823, Chairman McCall crafted a test compromise that would require origin-sourcing for sales of “tangible personal property” and require taxable services to be consummated at the destination / delivery location. This language was included in the omnibus fiscal matters bill needed to balance the budget. Stakeholders thought this would be a reasonable compromise bringing the state closer to compliance with the Streamlined Sales and Use Tax Agreement.

Destination sourcing for taxable services was set to take effect July 1, 2004. When the Comptroller began promulgating rules to require destination-sourcing for taxable services and provided notice to the business community, the regulated parties (pest control, landscape providers, etc.) realized the impact the change would cause and objected to both the Comptroller and members of the Legislature. The primary objection was that collecting on destination basis was costly and difficult. Service addresses don't always follow the jurisdictional boundaries of taxing entities and it is costly and difficult to accurately collect and remit on a destination basis. Some services are performed at locations without an address (oil wells). The additional cost of compliance was not compensated by the Comptroller and put an unnecessary administrative tax compliance burden on the business community.

As a result, the comptroller suspended the rule change required by HB 2425 and provided guidance that taxable service providers should continue to collect and remit local sales tax on an origin basis. The Comptroller's office never enforced the law and the destination sourcing provisions for taxable services were subsequently repealed by the Legislature.

**SB 1863 (79<sup>th</sup>, 2005) by Ogden – *Relating to Fiscal Matters*.** The Senate version of the bill repealed the "tangible personal property" language in HB 2425 in 78<sup>th</sup> that applied destination-sourcing rules to taxable services to bring them back in line with origin sourcing for all sales tax. The Bill Analysis for SB 1863 read as follows: *"Committee Substitute Senate Bill 1863 makes uniform the collection of city, county and special purpose district sales taxes on sales of goods and taxable services. It defines the amount of the tax due in connection with the comptroller's certification to municipal sales taxes. It also conforms the startup-date for a County District Sales tax with most other local option sales taxes"*

The provision to make sales tax uniform was not included in the final bill that went to the Governor. Destination-sourcing requirements for taxable services remained the law but also remained unenforced by the Comptroller after the 79<sup>th</sup> Legislature in 2005.

**HB 3319 (80<sup>th</sup>, 2007) by Keffer – *Relating to the Sales and Use Tax*.** This bill repealed the "tangible personal property" modifier language in the local origin sourcing statute 321.203 and 323.203 and clarified that these sourcing rules applied to all "taxable items". The effect of the bill was to bring the Tax Code into conformity with comptroller practice and guidance for all taxable items including taxable services. The bill passed both chambers without opposition.

Also during the 80<sup>th</sup> Legislature, while HB 3319 repealed the unenforced destination sourcing for taxable services, another bill repealed the destination sourcing requirements for transit authorities under Chapter 322 of the Tax code. When the Legislature originally gave transit authorities sales tax powers, it did not grant transit authorities the power to impose a tax on items shipped or delivered outside of their boundaries. In effect, this created "destination-sourcing" for companies located within a transit authority and placed both a collection burden on the business and a use tax burden on customers.

**HB 142 (80<sup>th</sup>, 2007) by J. Jackson - *Relating to imposition of local sales and use taxes on certain taxable items shipped outside a transit authority.*** This bill repealed the requirement that retailers located within the boundaries of a transit authority, collect and remit sales tax based upon the destination of items shipped outside of the Transit Authority's taxing jurisdiction. The filed bill only provided this 'administrative relief' for small retailers with under \$10,000 in annual sales tax receipts.

The House Research Organization report on the bill notes that the Texas Retailers Association supported the bill. The analysis of the bill is posted below:

**SUPPORTERS SAY:** HB 142 would provide a remedy to small retailers living in transit districts who must deal with complicated and inconsistent sales-and-use tax requirements when shipping an item to a purchaser living outside the transit district. Small retailers lack the resources and technology needed to easily compute and remit sales taxes for purchasers to whom they ship. For this reason, current law places a confusing and undue burden on the small businesses.

HB 142 would conform sales-and-use tax law governing small retailers in transit districts with laws governing retailers in other taxing jurisdictions. Typically, when a retailer sells and ships a product to a purchaser living outside that jurisdiction, sales-and-use taxes are assessed on a "point of origin", or point of sales, basis. This presumption is reasonable, given that the originating jurisdiction most likely is the one providing the services that support the retailer's business. Extending the point of origin standard to small businesses in transit authorities would provide clarity for sellers and buyers without significantly affecting the revenue sources of local jurisdictions in the state.

**OPPONENTS SAY:** HB 142 should not be limited simply to small retailers located in transit authorities, but instead should apply to all retailers. Current sales tax law as it applies to retailers in transit authorities is not consistent with laws governing other local taxing jurisdictions. The narrow provisions of HB 142 would exclude medium and large retailers who also struggle to contend with the requirements of current law.

The bill passed the House 135-0 with notable current Ways and Means committee members Bohac, Murphy and Martinez-Fisher voting in favor of the bill. Speaker Bonnen was also a member of Ways and Means during the 80<sup>th</sup> and voted for the bill both in Committee and on the floor.

The Senate took the "Opponents Say" argument to heart and repealed the destination sourcing requirements for **all** retailers located within a Transit Authority. The bill passed the Senate unanimously with the support of Chair Nelson and then senators Patrick and Hegar. The House unanimously concurred in Senate Amendments.

**NOTE:** It is important to acknowledge on the timeline of history that Dell, eBay, Amazon, Walmart, Zappos, StubHub, Costco, Netflix, NewEgg and most other notable retail websites had been popular and fully operational for many years. Forrester Research estimated that over \$175 Billion in ecommerce activity in the United States occurred in 2007 with an annual growth rate of around 20%. Ecommerce was well established and growing when the Legislature took the step to make sales tax origin-sourcing uniform throughout the state with HB 142 in the 80<sup>th</sup> Legislative session of 2007.

The last substantive Legislative review of the local sales tax sourcing statute (Tax Code 321.203 & 323.203) occurred in 2009 during the 81<sup>st</sup> Legislature. The origin sourcing statute at the time required a company to source the sale to the place of business in the state from which the item was shipped to the customer. This ‘shipped from’ statutory requirement proved to be an issue for companies operating more than one “place of business” and came to a head in the RoomStore reallocation dispute. The RoomStore is a national furniture chain operating retail showrooms around the state as well as several warehouse / distribution centers in major metropolitan areas. One community where a RoomStore distribution center is located was concerned that it was not receiving any sales tax from the location, even though it was an established place of business. RoomStore was provided with the statute and rule guidance and filed amended returns with the Comptroller. The result of these amended returns was a reallocation of local sales tax away from many of the RoomStore’s retail locations, to the distribution centers where the purchased items were ‘shipped from’.

The RoomStore reallocation had a significant negative fiscal impact on many communities. One of the communities suffering a negative reallocation brought suit against the Comptroller.

In an effort to address the statutory issue multiple bills were filed in the 81<sup>st</sup> Legislature to “fix” the issue of a purchaser walking into a retail location, selecting an item, paying for it at that location, and then having the sales tax allocated to the ‘shipped from’ location.

**SB 1202 (81<sup>st</sup>, 2009) by Deuell – *Relating to the collection and allocation of local sales and use taxes.*** Early in the session, SB 1202 became the negotiated vehicle to resolve the disagreement. Senators Deuell, Patrick and Ogden led the effort in the Senate with Representatives S. Thompson, P. Rose, L. Taylor and Paxton taking the lead in the House.

SB 1202 went through multiple draft versions after significant input and involvement by both public and private sector stakeholders, along with the Comptroller’s tax policy staff. The resulting language clarified that a sale is sourced “*where the retailer first receives the order provided that the order is placed in person*” and that this provision takes precedent over the ‘shipped from’ requirement when the same retailer has more than one place of business in the state. SB 1202 passed the senate 31-0 and was voted favorably out of House Ways and Means on May 14<sup>th</sup>.



Ultimately, the negotiated language in SB 1202 was added to ***SB 636 by Seliger – Relating to the imposition of the franchise tax and local sales and use tax, including the authority of a county or other local government to receive local sales tax information.*** The change to SB 636 was due to House Floor Calendar traffic and timing.

SB 1202 / SB 636 was the last substantive change to the intrastate sales and use tax sourcing statute in the state of Texas. There was a minor change to the ‘in-person’ sourcing provision made during the 2013 session (SB 997 by Deuell / B. Hughes) to extend a grandfather clause for a furniture distribution center project in Emory, Texas.

Finally, Chairman Burrows’ ***HB 1525 (86<sup>th</sup> Legislature)- relating to the administration and collection of sales and use tax involving marketplace providers.*** This bill from last session, made it mandatory for Marketplace Providers to source all third-party sales made via the marketplace to the delivery destination. The bill specifically allows the Marketplace providers to continue to source their own sales based on the existing origin sourcing rules in 321.203.

### **Other Notable issues:**

In December of 2007 after several years of lobbying by origin-sourcing states and CASTLE member communities, the Streamlined Sales and Use Tax Agreement (SSUTA) Governing Board met in Dallas and unanimously amended the agreement to allow origin-based sourcing for intrastate sales of tangible personal property and digital goods. Texas Comptroller Susan Combs helped negotiate the compromise with the 22 member states. The SSUTA Governing Board made the compromise in an effort to entice origin-sourcing states like Texas to fully adopt and implement the multistate agreement.

In the 2009, Ways & Means Chairman Rene Oliviera sought permission from the House to file the Streamlined Sales Tax compliance bill after the bill filing deadline. His motion did not garner the 100 votes necessary to introduce the bill.

According to tax software company Avalara, of the 45 states with some form of a sales and use tax, there are 11 origin sourcing states: Arizona, California, Illinois, Mississippi, Missouri, New Mexico, Ohio, Pennsylvania, Tennessee, Texas, Utah and Virginia. These states comprise almost 50% of the economic activity in the United States.

### **Business Sector Compliance:**

Destination sourcing is considered more complex than origin sourcing. This is especially true for small businesses and those companies with only one location. The administrative burden and legal jeopardy created by a destination sourcing requirement is real.

Companies are faced with a decision to calculate the correct destination tax on their own, and face either Comptroller audit consequences of penalties and fines should they get it wrong. The companies also face legal consequences from the plaintiff's bar via the threat of qui tam lawsuits should they either over or under collect the sales tax. Should a company decide to automate the sales tax calculations, they are required to buy compliance software and go to the expense of having that software integrated with their existing sales system.

The expense of software compliance, and the administrative / legal risks associated with incorrect application of complex destination sourcing rules create a real barrier to entry for new and small businesses. Large multi-state retailers and well funded organizations are obviously better able to navigate the complexities of destination sourcing.

Good tax policy requires enforcement. Currently, Texas merchants that collect local sales tax and incorrectly remit that tax to the wrong jurisdiction do not face any penalties, nor do I suggest that they should. Most errors are those of misunderstanding or incomplete information. A change to destination-sourcing, with its increased compliance expense, is ripe for merchant avoidance. With the Comptroller's long practice of not imposing penalty for incorrectly reporting (as long as the 2% maximum local tax is collected and remitted), there is no compelling interest for a Texas merchant spending the necessary funds to become compliant with a new complicated destination-sourcing requirement.

#### **Destination sourcing favors out of State merchants:**

The cost of compliance and administrative burden also puts merchants with only a Texas location at a competitive disadvantage to out of state businesses. HB 2153 by Burrows from last session allows non-nexus out of state retailers to collect and remit taxes in Texas on either a destination basis or the company may select a single rate for all Texas locations that the Comptroller will allocate among local governments based upon a formula approved by the Legislature. This option does not exist for Texas merchants that would be required to collect and remit sales tax based upon the destination of the taxable item. Texas is home to more than 1500 separate sales tax jurisdictions that makes compliance quite complicated and burdensome, especially for those small businesses changing from a single place of business under the current statute.

The Legislature and the Comptroller acknowledge the complexity and "burden" of destination sourcing for out of state sellers. The bill analysis for HB 2153 states as much in the Background and Purpose Section: *Concerns have been raised regarding the ability of sellers who are not physically located in Texas to collect applicable sales and use taxes. It has been suggested that identifying the correct local taxing jurisdictions and calculating the total local use tax due may be challenging for these remote sellers. C.S.H.B. 2153 seeks to alleviate a remote seller's **burden** in calculating the local use tax in Texas by giving these sellers the option to collect taxes using a single local use tax rate.*

## **Destination-sourcing negative revenue impact:**

**State of Texas:** A change from origin to destination sourcing will require a sustained and massive education campaign to the millions of Texas merchants with a sales tax permit. The change will require significant reprogramming and substantial IT resources to implement. And finally, should the Comptroller actually enforce the change to destination-sourcing, there would need to be additional Audit and compliance FTEs in the budget for the change.

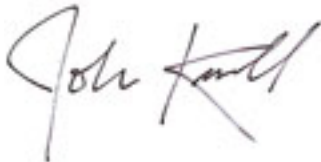
**Local Government:** Over 95% of Texas sales tax permit holders are located in an incorporated area and subject to a municipal sales tax in addition to other special district taxes like transit, ESD, fire and police control, economic development sales tax requirements. However, almost 25% of the Texas population is located in an unincorporated area and not subject to municipal or other special district rates. There will be an overall decrease in local sales tax receipts for any item delivered to a purchaser in an unincorporated area.

## **Summary:**

Texas' historic embrace of origin-sourcing for local sales tax has contributed to our state and local governments economic development success due to its simplicity and fairness. Destination-based sourcing is complicated, expensive and burdensome.

For these reasons, I encourage the Ways & Means Committee to continue Texas' long standing, business friendly, easy to administer origin sourcing tax policy for sales and use tax.

Warm regards,

A handwritten signature in black ink, appearing to read "John Kroll". The signature is fluid and cursive, with the first name "John" and last name "Kroll" clearly distinguishable.

John Kroll  
Partner